Consumer Finance Monitor (Season 7, Episode 17): A Close Look at the Consumer Financial Protection Bureau's Final Credit Card Late Fee Rule: Have Cardholders Been Dealt a Winning or Losing Hand?

Speakers: Alan Kaplinsky, John Culhane, Kristen Larson, Ron Vaske, and Andrew Nigrinis

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm.

I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now Senior Counsel of the Consumer Financial Services Group at Ballard Spahr. I will be moderating today's program.

For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted our blog since July 21, 2011 when the Consumer Financial Services Bureau became operational, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. To subscribe to our blog or to get on the list of our webinars, please visit us at ballardspahr.com.

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And I'm also very pleased to tell our listeners that our podcast show was recently ranked by Good2bSocial as the best podcast show among law firm podcast shows in the United States devoted exclusively to consumer financial services. Good2bSocial is a prominent law firm consulting firm owned by Best Lawyers. We're very gratified by this recognition from one of the country's leading social media consultants for law firms.

Today's podcast show is a repurposing of a webinar which we conducted on March 21, entitled, "Has the CFPB's Final Credit Card Late Fees Rule Dealt Card Holders a Winning or Losing Hand?"

Before I introduce you to our speakers today, and they'll be very brief introductions, except for our special guest, just to basically set the table, March 5th, the CFPB issued its final rule, which lowered the safe harbor late fee amount that can be charged by issuers other than small card issuers to $8. While that particular thing that they did, lowering that safe harbor amount to $8, has garnered most of the attention of the media, the final rule also includes other significant changes that merit attention not only by large issuers, but also small credit card issuers.

So we're going to cover the waterfront today. I mean, we're going to talk about how the final rule differs from the proposed rule and the existing rule, who is a small card issuer under the final rule, changes impacting issuers other than smaller card issuers, changes impacting smaller card issuers themselves, changes impacting all card issuers, operational implications of the final rule, impact on card issuers including regulatory considerations that are involved in mitigating lost late fee revenue.

We're also of course, but we're going to leave it toward the end because you never give away the punchline right at the beginning of when you're telling a joke, we're going to really take the proverbial deep dive into the litigation brought by the industry in the Northern District of Texas, the Fort Worth Division, which unfortunately for the industry has not been going so well. And then we'll touch upon Congressional Review Act and whether there's any hope of getting it tossed out on that basis. The answer is no.

Well, let me just say this. When we were planning for this webinar, I was concerned. Well, concern may be the wrong word, but I thought by the time of the webinar there was a very strong chance that a court probably in Texas would issue a preliminary injunction and that the industry would feel a sense of relief and have not as much interest in the nitty-gritty of the

rule and how to implement the rule and the operational and regulatory concerns. Well, was I wrong, as were a lot of other people, and John Culhane will get into that toward the end of the program.

So let me now turn to our speakers for today, and I hope my colleagues don't mind, but John Culhane, Ron Vaske, Kristen Larson are so well-known in the industry for being involved in many of our webinars and podcasts that I'm not going to tell you anything more about them.

But I am going to introduce, our very special guest, Andrew Nigrinis. Andrew previously served as the sole enforcement economist at the CFPB and he led the Bureau's economic analysis and evaluation in more than 70 cases. He's managed investigations relating to allegations of unfair or deceptive practices, fair lending, disputes between financial services providers and lenders, allegations of mortgage and student loan servicing issues, as well as credit card fees, dark patterns, debt collection, et cetera. He worked alongside state attorney generals as well as the Department of Justice and personnel at the Comptroller of the Currency on a broad range of consumer finance matters. He was there practically from the beginning when Richard Cordray was director and he basically worked for every director and acting director. He was there for the beginning of the term of Rohit Chopra.

So we're very pleased to have Andrew, who is a very experienced economist and who devotes a lot of attention to consumer finance, involved today.

We're going to begin now with the first item on the agenda, the final rule, safe harbor, and then the final rule, smaller card issuers. I'm going to turn the program over to my colleague, Ron Vaske.

Ron Vaske:

Thank you, Alan. The first slide we have here is kind of what we call a cheat sheet that just gives you a basic summary of the rule and the changes from the current Reg Z and differences from the proposal.

As Alan suggested, the difference, the late fee safe harbor amount depends on whether you are a larger card issuer or a smaller card issuer as defined in the rule. We'll take a look at that in a little more depth in a minute, but what in general it means is that if you, at any time during the last calendar year, had more than one million open credit card accounts, then you are a larger card issuer, one million or more. If you had less than a million at all times during the prior calendar year, you and your affiliates, you are a smaller card issuer.

If you're a smaller card issuer, the rule here doesn't change a lot for you. The big change really is just the change from the existing safe harbor amounts from $30 to $32 for the initial late fee violation, and $41 to $43 for any repeat violations within six months.

The big change though is if you are a larger card issuer, a million accounts or more. There, the late fee safe harbor goes all the way down to $8, and that applies to both the initial violation as well as any subsequent violation, any repeat violation within the next six months.

For smaller charge card issuers, you can still take advantage of the alternative 3% of delinquent balance late fee amount that are, at least for late fees that are applicable to balances at least two cycles delinquent. That's in lieu of the alternate or the second repeat violation fixed amount.

For all issuers, there is no change in the safe harbors for other penalty fees, only late fees that are affected, other than increases in the amounts from $30 to $32 for the initial violations and $41 to $43 for repeat violations.

The other good news here is that there's no change in the absolute cap on penalty fee amounts, including late fees, which will remain at 100% of the violation amount. The proposed rule had a cap applicable to late fees that would've capped it at 25% of the amount of the delinquent balance. That did not survive. That did not make it into the final rule.

A little more definition onto what it means to be a smaller card issuer. That is, as I mentioned, if during the prior calendar year, so looking to start now in 2023, if at any time the issuer had one million or more open accounts, that is a larger card issuer. Open account is defined as an open credit card account. Credit card account has the Reg Z definition, and it's an open account if the card holder can obtain extensions of credit on the account or there is an outstanding balance on the account that's not charged off. Temporary suspensions for any reason are still considered open accounts.

The $1 million threshold applies to the issuer together with its affiliates, so affiliates as defined under the Bank Holding Company Act. The issuer and all of its affiliates combined had one million or more accounts during the prior calendar year is a larger card issuer.

From there, I'll turn it over to John to talk about fees based on costs.

John Culhane:

Thanks, Ron. I'm actually going to talk about fees based on costs and then just I'll have a few comments on the change that wasn't made that Ron noted about the 25% cap.

I don't know that there's a lot to say here at the moment. Basically nothing happened here. This is the provision as it existed prior to the CFPB rulemaking proceeding. And I guess the odd thing about this, if you look at the supplementary information materials accompanying the text of the final rule, is that for all that the CFPB has been throwing the Federal Reserve Board under the bus for its prior rulemaking in this area, it pretty much agreed with the Federal Reserve Board. Well, it basically agreed that the Federal Reserve Board got it right when it came to deciding how to determine fees based on costs.

There's some discussion of the CFPB's interpretation of the Y-14 data. Andrew will be saying more about that later, but again, this is really surprising in some respects, agreement with the Federal Reserve Board.

So where are we? Well, we're right where we used to be. I don't think we've ever seen anybody do this up to now, but it seems likely we'll see more attention on it in the future.

So what are the rules for fees based on costs? Well, you can set your late fee based on costs. The amount has to represent a reasonable proportion of the total costs incurred as a result of the violation. Once you set it, that's only good for a 12-month period. It has to be reevaluated every 12 months. If you decide that your costs no longer support the fee that you had established, then you've got 45 days to lower the fee. If you decide that your costs have increased, so you determine that your costs have increased and so you want to increase the fee, then you've got to go through the change-in-terms process. You still have to go through that process, but this happens to be one of those situations where there's an exception to the right to reject, so cardholders would not get the opportunity to opt out here.

Most of the comments about this focused on the exclusions from the cost analysis, and as I said, the CFPB just kept the existing rules in place, and the theory for the existing rules is you're allowed to recover costs that are mitigating a loss or a violation of the account rules, but once that violation has occurred and you've charged off the account, then anything that happens after that point is mitigating a loss. It's not really related to costs incurred with the late payment or deterring late payments. So the rules that existed before, as I said, have stayed in place.

Things that are excluded, you can't allocate costs of holding reserves against potential losses to these costs. You can't allocate the cost of funding delinquent accounts. You can't allocate costs that are incurred after an account is charged off. And you also can't allocate your forecasting around accounts that will go and your management of accounts in trying to predict what accounts might go delinquent in the future. Again, I'll just say what I started with, nothing really changed here. The CFPB kept this rule basically in place as it was.

Let me just make a few observations about the change they didn't make. As Ron mentioned, they decided not to impose an additional cap on the amount of the late fee, that is limiting it to 25% of the amount of the required minimum periodic payment. This is kind of an interesting section in the supplementary information as well because there were a lot of concerns expressed by the industry that that kind of cap would not allow the recovery of fixed costs that credit unions and smaller issuers tend to have a high percentage of accounts where they have small minimum payments, and they also tend to have a higher percentage of pre-collection charge-off costs and that this wouldn't be sufficient to allow them to recover costs.

And while the CFPB was by and large dismissive of comments about cost recovery, here they agreed with the comments that they received and then decided to jettison the 25% cap. Obviously, with an $8 fee, that would've meant that minimum payments under $32 would've been even further restricted, but that's gone. So let's resume a discussion about what's in here and what's permissible now.

Kristen Larson:

And so what we wanted to cover next is that a lot of issuers have historically used this because of the safe harbor fee being much higher, but it is still permissible to charge another higher fee. Take, for example, that someone sends in a payment and that payment is returned unpaid by the paying bank. Instead of charging the $8 late fee, if your return payment fee was $25, for example, $30, you would be able to charge that fee instead of the $8 late fee.

Now, I know for a lot of issuers, this will require some additional system programming, but again, that's another alternative to think about in addition to what John mentioned about looking at whether you want to look at fees based on cost.

And with that, I'm going to turn it over to our guest speaker, Andrew, to talk a little bit more about the economic analysis related to the rulemaking.

Andrew Nigrinis:

Thanks for inviting me. I really appreciate the invitation to come to speak to all of you. It's a great honor. Like Alan was saying, I worked at the CFPB in the Enforcement Office for many years, and while I was there, a lot of things changed, and while I was leaving, there was this new focus on junk fees.

What's interesting about junk fees is the CFPB repeatedly cites that there's a lack of competitive forces with backend junk fees. As you all know, it was in the State of the Union Address back on March 8, 2023, and this is part or this seems to be part of a program to crackdown on junk fees. I personally take offense to the idea that these are junk fees because one can easily avoid the fee by paying on time, and also that, as I will show later, there's no indication that there's a lack of competitive forces in this market.

So the data to use the final rule, so the key is that, as was said before, is that fees must be reasonable and proportional. Of course, I don't have to tell all of you, you're lawyers, the problem is one of definition of what constitutes reasonable. According to the CARD Act, a reasonable fee has to be the cost incurred from omission of violation, deterrence, conduct of the cardholder, or other factors. So it's pretty nebulous as to what it means. It appears the CFPB wants to consider reasonable proportional as a relation to cost structure.

The CFPB considered four primary data sets in developing the 2023 proposal, and of course now it's 2024, the actual rule. One is the Y-14 data set, and this is data from the largest banks that is collected by the Federal Reserve Board. The other is the Y-14+ data set, which is an augmentation of the first data. The third is credit card data debt collection data received basically from their authority to receive data. And the fourth is the Credit Card Agreements Database. They have this really large database where they just basically get the terms and services from everyone.

Now, the Y-14 data, so the analysis refers to the Y-14 seventh-month data, and basically what they do here is they're trying to get to the core question of deterrence. So what this data does, it has a late fees amount paid by each month, along with balance details, various account and borrower characteristics such as origination, credit score, et cetera. The analysis, what they do is they look at six billing cycles and they investigate whether a reduced late fee amount in the seventh month prompts a noticeable increase in late fee payments. In the recent years, they've supplemented this data with data from 2020 and 2021.

So their big conclusion is that there is not much of an increase in default in month seven. I don't think it's very earth-shattering of a result. There's clearly selection bias here. If you've missed basically six late payments, the seventh one is not going to be that impactful, the amount of it. That's one piece of analysis that they do.

What they then do is they use data from the Y-14+ data, which is an extension of Y-14. So essentially, what they do is they lower the asset amount that they need to be in the dataset. They collect the data, they find more things to do their analysis. However, it's really important to note that by their own admission, and I got this quote off the, I believe, the 2023 Credit Card Report, and it says that, "The Y-14 data should not be considered representative of the uncovered portion." So basically, they know very little about what the industry is if you're not in the Y-14+ data. The Y-14+ data is going to cover a lot of financial institutions like credit unions, smaller banks, things like that. And of course, if it's not representative of the uncovered portion, how can it be that representative of the entire market? So they're using data that's not very representative and they're making these kind of big general, sweeping claims to change the industry.

Now we get to the point of cost-based calculations. I kind of referred to this as the battle of the accounting standards. Personally, I think this is completely the wrong way to go about things. I more think that the appropriate, reasonable, proportional standard is not to get fees down to cost. You should actually be getting fees to incorporate other things that fees do, which we'll talk about later, such as deterrence and risk management.

So the CFPB, to put it politely, and I'm from Canada originally so I always have to try to put things politely, but the CFPB is trying. It's being... I don't want to be too aggressive, but they're being dismissive over what I think are legitimate complaints about how costs are calculated.

So what they do is they, on the Y-14M data, and if you're getting confused between Y-14, Y-14+, Y-14M, I mean, unless you've worked in bureaucracy, you don't really, really get a fine appreciation for all these different nomenclature. But the Y-14M data is also a Federal Reserve data set, and it was actually created originally for stress testing purposes, and the data points they use or the fields they use are total non-interest expense, collections expense, and fee income or late fee income.

I don't think it'd be the most fascinating thing in the world to get down into the nitty-gritty of how fees are split up in the accounts, nut as anyone who's ever worked in a large organization like a bank knows or a financial institution knows, there are a lot of ways to allocate costs, and a cost allocation system that's reasonable for stress testing purposes and how you allocate costs across different divisions and product lines may not be the best way to do it when you're dealing with something like credit card late fees and incentives for defaulting and stuff like that or being late. But essentially, I'm going to walk you through the methodology.

First off, they exclude collection and charge-off costs, as John mentioned, but they estimate the share of total collection costs that derive from commissions paid to collection agencies and recoveries as a proxy for costs incurred after charge-offs. And then they take this estimate to the Y-14M data, and they essentially get a ratio of the net fees before the charge-off collection. That's terrible grammar, but the net fees over before charge-off collection costs. And what they essentially find is a difference of a factor of five. They find that fees were $42 beforehand, they divide by five, they get something slightly bigger than eight, they round it down to eight. It's kind of shocking how incredibly simplistic this is. It should be, it's not very well... I mean, yeah, I'm trying to be polite, but it's not a very profound methodology.

So one thing to keep in mind was that a lot of these costs are reported in the Y-14M data and therefore, they're essentially for stress testing. The key thing is that the instructions are somewhat vague and there was no attempt made by the CFPB to take this data and to make it uniform, to standardize it. And also, well, I'm kind of repeating myself here, and to split it between different bank functions.

Here, the table I got from the Bank Policy Institute is really good. Essentially what it does is it shows how you could split costs between different categories and different types of costs.

One big thing to keep in mind is the exclusion of the charge-off costs. And the reason why that's important is the Fed excludes cost of losses, but the CFPB interprets this to include post-charge-off collection costs, effectively ignoring the debt collection industry and how they work with credit card companies. And the reason why this is really important is because companies of different scales have different, what we like in economics to call the make-versus-buy decision. Do you want to do something internally or do you want to make it into an external decision? Very large credit card companies will handle a lot of their collections internally, and you can see other types of companies will outsource that. This really matters because it will basically make differences between the different types of institutions and types of cost-reporting data that they report.

Also, there's a real thing, and I've noticed this in a number of different roles that I've worked on in the last year or last few years, but there are a lot of issues about whether to weight by accounts or transactions or by institutions. Well, the reason why that's important is because if there's scale in banking, and it's not unreasonable to think that there's scale in banking, very large banks can report much smaller unit costs.

So the figure on the right nicely put together shows that the difference between taking a weighted average of the fee-to-cost ratio, one is using accounts, and the other one is using weighting by institution. And you can see that there's a divergence. And the reason why is because when you see a data pattern like this is that there's very large institutions that have lower costs and are essentially driving the data. By using accounts as opposed to institutions, what you're essentially doing is you're driving costs to the smaller level, which makes it hard for other firms to compete, and I don't think it's unreasonable to want there to be lots of competition and diversity in the market.

Also, the data is from January of 2016 through March of 2022. There's an emphasis on the sub-period since August 2021. Well, I believe something happened in 2020 that makes all the data very strange, and before the CFPB goes and makes a multi-billion-dollar decision that could really change a major industry, maybe just waiting to cool your heels a little bit to see where the market shakes up after COVID and also the COVID responses like sending checks to everyone would actually be probably a good idea. But yeah, so they do a real emphasis on the last few years of their data, which of course is probably not representative of what's going to be occurring in the industry for the next few years. I mean, let's hope it's not representative of what goes on in the industry for the next few years since no one wants another pandemic, which gets to my major point about the CFPB. This is less an economics point and more me as a former CFPB bureaucrat.

So from the CFPB, their data, you can find it on the webpage, they like to emphasize that they leverage full-potential data to meet their mission. It means they are proactively acquiring, analyzing, and publishing high-quality data. They believe they're a data-driven agency, a 21st century agency that uses data to inform their decision-making. The CFPB is committed to improving transparency and accessibility by providing the public with timely and reliable data that will enable them to make informed decisions.

Well, also from the CFPB, and this code actually comes from the final rule, the CFPB does not agree it is improper to cite supervisory or other confidential data as part of their statutory functions, and it was lawful for them to get it, so they're going to do it here, and they basically released some aggregate data.

My point is that if you're going to make such a huge change to such a major industry, you should be willing to show the data up to as much as possible. Also, using a data set designed by the Fed for a different purpose was probably not appropriate given that CFPB has the statutory authority to collect data. And given that the RMR, if you're not in the know, the Research Markets and Regulations Office at the CFPB, has a $79.7 million budget in 2024, there should be some transparency, and quite frankly, they should be releasing as much as possible their data and their codes. There are vague statements in there about how things pass standard statistical levels. I have no idea what kind of models they used, whether those models were appropriate. I can't tinker with them in order to see whether they did it correctly or anything like that. And neither can anyone else in the industry do this.

So I guess the point of this is at some point, if you're going to say that you're an open, transparent agency trying to be a 21st century agency, you can't act like a 20th century agency telling people to, "Accept what we tell you," and, "this is the way it is." You should open your books and allow us to take a look and to make sure that... What's the old legal expression? Sunlight's the best disinfectant or something like that, some Supreme Court thing? That would be good here.

So I just want to get into very briefly because deterrence, well, the core model of deterrence is the Becker model. Like any really good economics model, it's groundbreaking when it comes out, and then it quickly becomes just common sense. Essentially, a person commits an activity if the expected benefit is greater than the expected cost. The benefit of a late payment is a form of one-month lending. It's strange because CFPB acknowledges this. In the quote down there, they tell you that if they give you a scenario or they say that $8 represents a 730% APR, I mean, it's a very stylized example saying that the minimum due was $39. Again, how representative that example is is completely up to... Can't be confirmed because there's no data to go through to analyze it.

But they're basically saying is that, "We're going to get the old model of deterrence and now we're changing the punishment terms to $8 or the penalty term to $8, and therefore there will be no increase in late payment behavior." They say there's no meaningful increase in late payment behavior. They do this without providing evidence or elaborating what would happen when they weaken deterrence. They say there are additional incentives for issuers to emphasize reminders of automatic payments and other mechanisms similar to better payment behavior.

Again, this is all done in a very unsubstantiated way. There's no way to really confirm all this. And as I would like to point out is that if you're the one who's making the claims that goes outside the bounds of common sense, there should be an expectation that you back up your claim with actual data.

And what's interesting is when this part of their rule, they basically are treating consumers like they're making rational choices in the market, and that's essentially what a late payment is. It's a rational choice to make the late payment. Credit cards don't exist in a vacuum. They exist in a competitive market for other types of lending.

Unusual claims need to be substantiated. I don't think that's a controversial thing to say. The Bureau says that there's available empirical evidence that an $8 late fee payment will not change the behavior of accounts based on the Y-14 data. I was, when writing this, I decided to be a little cheeky and say that, "Well, if you really believe this, please convince the IRS to reduce its late payment penalties to the government." But of course, they're not going to do that. But the upshot is there's no data, there's no code, there's no transparency.

The CFPB does reference the academic literature. They reference a paper by Agarwal who actually shows that there's a learning via fees. He has a nice paper using a proprietary data set. Now, admittedly, it's January 2002 to December 2004, but I like to say human behavior hasn't changed that much since the early 2000s. Well, my younger daughter probably does think she's fundamentally different than me, but anyways. The monthly frequency of late payments go down from 36% to 8% over time as accounts age. The Bureau rejects this study by saying it's of limited relevance mainly because of the data period and also not addressing the actual $8.

I would like to point out that when you have a $79 million research markets and regulations office budget and some other economist has shown you how to do this analysis, if you're going to do this in the future, you should probably update the analysis.

Another paper they reject is Grodzicki. He finds that late payments are more likely when fees are less costly. Again, this falls under the economic literature of not groundbreaking work, but nice to have an estimate. They determine that he's not sufficiently robust data because a lot of his analysis came from 2010-2011, which of course was a time period of great upheaval due to the Great Recession, but of course I can make the exact same claim about the CFPB using 2020, 2021, and 2022 data.

Gathergood was actually an interesting paper. He looks at late fees in the UK and he finds there's 6% in the first month and they fall to 2.5% by the 23rd month, mainly because the initial late fee, they set up automatic payments, things like that. Admittedly, this is not US data, but it's interesting given, again, the CFPB's budget and all their resources, which would rival most academic economics departments. They should be able to look into issues such as this.

All right, risk management. Well, I actually started my career in risk management for a while, and as anyone who works in credit cards, there's a limited ability to price risk with credit scores. I mean, you do your best. The better you're able to do it, the more profit you can make. There's a virtual cycle of incentives there. I would also like to point out that on other types of rules, the CFPB is trying to make credit scores less predictive. One rule that is, for instance, the debt collection rule, medical debt collection. Credit cards would need... If you know less about your consumer and there's less predictive, obviously you would expect lenders to be more cautious and to limit credit lines and possibly increase APRs.

Late fees allow the person to face higher costs reflecting the delinquency risk. So when you give a late fee, it really says something about you. And also, devices by banks and financial institutions to get people to pay on-time payments increases the signal value of the fees. So if you give automatic payments, you give text message reminders, you do all these things for the customer and they're still late, it just amplifies the signal value that they are a bigger risk than you thought they were when they signed up for the credit card.

Also, people do default and late fees allow banks to claw part of the amount back so their exposure at default is less, and higher fees encourage consumers to reduce balances. And of course, Agarwal, a really nice paper that I mentioned earlier, shows that late fees drop as accounts ages. I feel like I'm going over time, so I'm going to go over quickly.

This is my favorite graph from the CFPB. Basically what they're showing is with the Y-14 data that if you're 30 days late, 60% of late payers pay within 30 days. It reminds me of a Simpsons quote. It was a joke where he's picking football games and he's like, "Well, when you're right 52% of the time, you're wrong 48% of the time." And Homer's like, "Whoa, why didn't you say that before?"

Well, of that 60% of people who eventually pay, well, conversely, that means 40% of people are not paying in the first 30 days, which means they're approaching the 90-day delinquency really quickly. And given that 3% of accounts, roughly, given whatever the economic cycle or where we are in the macroeconomic cycle at the time, only 3% of accounts ever really go delinquent, having a signal of 30-days late that gets you 40% to the two-thirds line, that's a very strong signal, which means late fees are very valuable as a risk management device, and it also means that as deterrence goes down, the value of that signal is going to go down, which means managing risk is going to become harder. I just wanted to emphasize that part.

But again, the CFPB seems to forget that there's competition in this market. So how many issuers are needed for there to be competition? 2, 10? Well, the CFPB says there's 4,000 financial institutions that offer credit cards. And I took this graph, again from the Bank Policy Institute, and they got it from S&P Global Market Intelligence. So basically, the good old-fashioned Herfindahl-Hirschman Market Concentration Index, which is standard in DOJ-FTC work, and it shows that the issuance of credit card does not pass any of the concentration measures.

So the key thing is if consumers are perfectly rational and they make decisions, they self-select into different types of credit cards offering different terms and different types of late fees. Well, to get around economic rationality, the CFPB hangs its hat heavily on behavioral economics and trying to get into what they consider rational and attentive consumer standard. So there's been a push in the last maybe 10 years of a lot of behavioral papers talking about the salience of these in different industries. One of my classmates did a paper. Two of my classmates actually because we were all classmates together. They did it on cell phone usage and going over in your minutes. Of course that became a moot issue since now we get unlimited minutes. Well, there's been some papers on financial products using the same logic saying that consumers, some people just don't pay attention, they pay the late fees, and they're subsidizing those who do not pay attention.

Well, the problem with behavioral economics, I'm just going to jump to the next one, is that there's no general theory of behavioral economics. Now, Todd Zywicki over at George Mason University, he has a great paper on this if you ever want to read it. It's a law theory paper, but it's a really good one on the problem with behavioral economics, the fact that there's a lack of a general theory on behavioral economics. So if you say that 15% of people are not salient or don't have a salience on late fees, well, that's a population measure. Are those 15% of the people who purposely pick credit cards with low late fees because they know they're going to trip the wire and then they go out of their way to set up automatic payments and other types of commitment devices?

Well, many of these ideas the CFPB does are essentially unarticulated. They cherry-pick parts of the literature that serves their purpose for rulemaking. It's almost embarrassing to call this a cost-benefit analysis because there is almost no cost-benefit analysis in this rule. But in the behavioral economics, there's things like mental accounting. I put my money in different boxes and I manage those boxes. They don't cross. So you see this sort of behavior where people will carry one type of debt and then a higher type of debt and they won't borrow from one to the other in order to mathematically save money on interest rates or something like that. Okay, there are papers that show that this phenomenon exists, but how does it exist in the credit card market? Do people have the next-point commitment devices to avoid their temptation bias?

Hyperbolic discounting, the desire to... Why do tomorrow when you can goof off today kind of deal, kind of put off the future, be-present bias, and then of course overconfident where you borrow more than you think you can reasonably pay back, these are all behavioral biases. They're kind of invoked in the final rule of willy-nilly all over the place, but there's no systematic analysis as to which ones apply, what's a population statistic, what applies to particular people, and whether people have a way to get around it.

So just a quick summary. I expect there to be an increased frequency of late fees caused by lower payments. Defensively, this means there's going to be a change in annual percentage rates, APRs, credit limits, minimum payments, and other credit card terms. The increased risk of charge-off and losses means that basically defensive behavior. There'll be a decrease in access to credit and reduction in credit limits for customers with low credit scores caused by lower late fees.

I mean, the super prime people who will just use their credit card purely as revolvers, they're not going to be influenced by this, but the subprime is going to be badly hurt. And to give you an idea, 47% of subprime accounts paid no late fees. So it's not just subprime late accounts that are going to be hurt. It's going to be the subprime accounts who can't distinguish themselves from the late payer, so kind of the responsible subprime accounts who want to build their credit score and move up to a higher one.

And then just to summarize also, it also seems like, and this is me just on a soapbox talking at this moment, it seems like the goal of a lot of these regulations is to standardize banking to the point that there's going to be very little variety. Admittedly, the carve-out of one million accounts is at least leaving that part of the market out or to a limited extent. Standardization of banking means there's going to be less diversity in the market and probably a race to scale, which I don't think this regulation is good for the consumer, and I think it's poorly thought-out. I could be wrong. It would be nice to see a detailed analysis to show me if I'm wrong. And given that they want to change, make billions of dollars of changes in the market, there should be

transparency, there should be as much as possible the attempt to show their data and to show their code so that we can make sure that there's an honest assessment of the cost and benefits of this proposed rule.

Kristen Larson:

Thank you, Andrew. The next thing we wanted to talk about, which Andrew covered briefly, was the impact to cardholders. Again, most people in the industry know that transactors and revolvers really shop differently for credit card terms. Final rule is expected to help a limited number of revolvers who aren't paying on time, but again, adversely impact all cardholders. As Andrew mentioned, the $8 late fee is not likely to encourage cardholders to make timely payments. Impact to the cardholders is they're going to pay more interest charges and it could impact their credit scores.

Some of the changes that cardholders may experience include increased minimum payments, addition or increased annual fees, increased interest rates, lower credit limits, and what kills me is fewer credit card rewards or the elimination of rewards program. Now, this is something that we saw when debit card interchange was regulated as well, that that was one of the downstream impacts.

Next, we'll talk about the impact to issuers. We expect there to be additional compliance costs obviously with revising disclosures, reprogramming systems and statements, additional compliance costs. If you are going to use the fee based on costs, annually you're going to have to update your disclosures, your statements if that fee changes. Additional costs, if you are in a correspondent banking relationship or a retail partnership for your credit card programs, you'll probably need to renegotiate the cost structure there in terms of the fee sharing based on the potential card portfolio being less profitable.

We also expect to see an impact on credit card securitization trusts. There'll be changes to credit card product repricing, product offerings. It's going to reduce competitive products, that's for sure. There'll be higher credit losses and more default exposure.

Another thing to think about is if you have a card portfolio and you're a smaller bank who, if you were to just issue on your own, you would be subject to the exemption that Ron talked about earlier and you instead have a joint marketing relationship with a larger issuer, you're not going to be covered by any of the exemptions. And so some of those smaller banks who could qualify may want to revisit, but a lot of times they rely on the larger issuers because they don't have the infrastructure in-house to run their own program.

The other thing that may be an impact, like I said, we saw a similar impact in the debit card interchange fee regulation, where even though the small card issuers are going to be exempt, they have the possibility where there may be economic competitive pressure for them to lower their late fees so they can remain competitive with the larger issuers. We have a slide that I just wanted to share, that the CFPB is having some attacks on other credit card pricing. They're going after margins, they're going after interest rates.

And so now is the point where I turn you over to John. This is the part you've all been waiting for. He's going to talk about the legal challenge. Take it away, John.

John Culhane:

Well, I think at this point, rather than launching into the history of the litigation and the different arguments that are being made, I probably should preview where we're ending up, and I'm going to invite Alan to jump in and join me in commenting here.

So we pretty much expected what would happen after the CFPB issued its rule on March 5th. There's a race to Texas, the Trade Association's file attacking the rule, and when it gets to the CFPB's turn to brief issues here, they raise the issue of venue. That is, is this really the right court and is there enough of a connection to the Fort Worth Division of the Northern District of Texas to make it appropriate for this court and Judge Pittman to hear this case? And as we wind through that, we get a scathing order from Judge Pittman denying a motion for expedited consideration of the requested preliminary injunction prior to ruling on venue. And I think we get about as strong a signal as we could possibly get from a sitting district court judge that he's not going to decide the case.

He, I think, made it clear that he didn't like the forum-shopping going on here. He didn't like the impact on his docket and the number of cases he has to wade through. And he particularly didn't like being lectured to, at least this seems to be the way he

characterized it, being lectured to by non-Texas lawyers, lawyers from Washington D.C. telling him how to run his docket and how to run his court and how to make decisions. So he really blasts the plaintiff's attorneys. He's invited the CFPB to file a motion, a notice of intent to transfer, which they did, and basically set this case up for transfer to another district court.

I think he's going to be very careful moving forward to avoid doing anything that might look like a final decision on the merits that would allow for an appeal, an appeal that could result in this case coming back to his docket. So he's not going to dismiss the case for improper venue, he's probably going to transfer the case, transfer would not be an appealable interlocutory order, and I think our best guess at this point is he's going to send this case to the D.C. District Court.

Alan, anything you'd like to add here, and if not, we'll-

Alan Kaplinsky:

John, I think you've done a very good job of summarizing events that have occurred so rapidly that it's been very difficult for us to keep up with it on our block. I would expect that the CFPB will be filing its actual motion to transfer very quickly. I think it probably it'll get filed today. Don't you think, John?

John Culhane:

Yeah, its venue brief is due today and I have to think it's going to, although we haven't heard that it's been filed, you have to think that it's going to include their transfer.

Alan Kaplinsky:

That would be the right strategy for them to pursue because as you point out, an order transferring venue is not an appealable order. It's considered interlocutory, and therefore if he does transfer it, which I think it's almost a certainty he will, that can't be appealed to the Fifth Circuit. I think it's extremely likely that the CFPB will ask for the case to be transferred to D.C. I can't imagine actually any other venue that the CFPB might designate as being the venue in which the case ought to be heard rather than D.C., which is of course the main place where they are located.

And of course this is not a good result for the industry. It doesn't necessarily mean, and I don't think it does mean, that the industry is going to lose. I still think the industry has much stronger arguments for invalidating the $8 late fee safe harbor, but it's different politics involved. District of Columbia, Federal District Court, I think not dominated by conservative Republicans as a lot of the federal district courts are in Texas, and there are more liberal judges on that court. The D.C. Circuit Court of Appeals, which is the place where the case goes after the judge decides what to do, also more liberal, much more liberal than the Fifth Circuit Court of Appeals. The Fifth Circuit being the case that founded the CFPB was unconstitutional.

So this is going to prolong this case, and I think what it means is that for credit card issuers, they cannot just stand still. A week ago, I think the general consensus was that or the prevailing wisdom was that there wouldn't be a need to expend a lot of resources coming into compliance with the rule. Now, I think anybody who doesn't start getting the gears in motion is really making a big mistake because while everything may turn out fine by May 14th, nobody knows what the outcome is going to be.

John Culhane:

I just want to go back and correct one thing I said about timing. It's actually the plaintiff's venue brief that's due today, so that's the industry brief and the CFPB's venue brief is due, I guess, it would be Tuesday of next week. But there's no question that their venue brief is going to include a motion to transfer. So they're fighting on procedure; they're not fighting really on substance.

We can talk about and we should talk about the substantive challenges to the regulation because I think they've got an awful lot of merit, and I don't think it's a foregone conclusion that a transfer to the D.C. District Court, which has a lot of experience dealing with administrative procedure in dealing with and reviewing agency regulations, is just going to kowtow to the CFPB. But let's talk a little bit about what those substantive arguments are.

So the plaintiffs have argued that the rule, which as Andrew indicated, is not very well-supported by economic data, fails to comply with the Administrative Procedure Act for a number of reasons. They've included a CARD Act count, a Dodd-Frank count, sort of mainstream Administrative Procedure Act counts, and then even a Truth in Lending Act count regarding the effective date. So let me go through those just a little bit and then we'll try to leave some time at the end for discussing where we are.

The first count that's tied to the Administrative Procedures Act is that the CFPB didn't even pay attention to the requirements of the CARD Act and it really made no effort to set standards for assessing whether the amount of a penalty fee is reasonable and proportional to the omission or violation to which the fee or charge relates. Andrew has, I think, laid out the deficiencies in the analysis and plaintiffs have argued strongly that the $8 safe harbor doesn't allow issuers to charge fees that have any real deterrent value.

The industry has also argued that the CFPB hasn't even paid any attention to the obligations it has under Dodd-Frank when engaging in rulemaking to look at the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to financial products and services. As we've discussed, it seems clear that one consequence of this rule, should it stand, is that there will be reductions in credit limits. There will be increases in minimum payments, and some consumers who might've gotten credit card accounts prior to the enactment of a rule like this are just not going to get accounts. Those are the subprime consumers who just don't have an ability to distinguish themselves and show that they are consumers who will be able to perform and pay on time.

Further, in terms of the arguments that have been made, I think this is kind of a real easy attack on the CFPB. Their actions were arbitrary and capricious. They didn't engage in reasoned decision-making. They didn't explain their reasoning adequately and they certainly didn't support their conclusions with substantial evidence, all of this tied to the economic analyses that Andrew discussed. They didn't make available for public comment or review the data on which they substantially base their conclusions making it difficult for the industry to respond fully.

And I think one of the very strong points here is that there's a long-standing rule in the Truth in Lending Act that requires that the regulatory agency in question issue rulemakings on kind of a rolling basis. We used to see this with the old official staff commentary where we'd get an official staff commentary six months before the effective date and then six months later, it would take effect. The same with other rules. There's a specific provision in the Truth in Lending Act that requires regulations, that require disclosures that differ from the disclosures previously required to have a delayed effective date of October 1, which follows by at least six months, the date of promulgation. And here, as we have discussed at length, this rule was adopted on March 5th. It was published in the Federal Register on March 15th, giving a May 14th effective date, and a time period that's so absurdly short, there's simply no way for the industry to comply.

The plaintiffs, not surprisingly, sought a preliminary injunction motion, tried to get an expedited hearing on the preliminary injunction motion. As we discussed, that didn't work. I think there are really strong arguments here as to why a preliminary injunction is important, not the least of which is the impossibility of compliance in the time that's specified.

I want to just characterize the CFPB's response at a high level as sort of a, in response to the complaint that they didn't follow appropriate procedures to appropriate analyses, they're saying, "Did too, did to. Ne, ne, ne, ne." And that's kind of it. They just are, I think, largely hoping that this rule won't be contested in a form favorable to issuers and they'll just be able to sneak by on what they did.

Is venue proper? Very briefly, Judge Pittman, in response to the briefings, issued an order saying that he was weary about an attenuated nexus. We all thought he meant wary, but it now seems maybe that he really looked at his docket and he did mean he's weary of dealing with cases that he feels don't have a sufficient tie to the Fort Worth Division. So we are going to have briefing on venue again. As we said, we really expect that the judge has signaled where this is going to come out. He is going to reject the contention that venue is appropriate. He's going to transfer the case to the D.C. District Court, but that doesn't mean necessarily that the D.C. District Court will just rubber-stamp what the CFPB has done here.

Okay. The motion for the expedited consideration of a preliminary injunction was denied. That produced the scaling order we talked about.

So Alan, you want to say a few words about a Congressional Review Act challenge and whether that has-

Alan Kaplinsky:

Well, I already mentioned it at the beginning. There's no hope of that being successful primarily because even if such a resolution were to get through the House and the Senate, it's the certainty that President Biden would veto it, as he did the 1071 Rule. In this case, this late fee rule's actually part of his platform for reelection. And with this compressed the way the effective date happening so quickly, there's no way this could be pushed off to the next Congress. So, no hope there.

I guess final observations about the case, we're running short of time, but does anybody else, John or Kristen or Andrew, Ron want to chime in with anything?

John Culhane:

Well, if no one else wants to chime in, I think that the CFPB, I think that I'm wondering if this line for small issuers wasn't designed in part to make this a difficult case to bring in Texas because of the difficulty of finding a large issuer available to support venue.

The other comment I have is that this seems to be done in such a way that it's not just a reduction to $8. It's going to squeeze the industry so much that the simple solution may simply be to not assess late fees at all for some short period of time and then circle back, to just turn off the late fee function as a systems matter.

Kristen, Ron, care to comment on that?

Kristen Larson:

Yeah, John, I think you're right. I mean, just from being in-house all those years, it's very difficult to quickly implement a change, to test it, to do it, ensure you're doing everything correctly, to update all your media and disclosures. It's just a very difficult task for a financial institution to achieve in such a short period of time. And so my final observation is everyone's been dealt a losing hand here.

Alan Kaplinsky:

Well, other than maybe a President Biden and Rohit Chopra.

Andrew Nigrinis:

Well, to follow up on all the optimism, my worry is that if you look at credit card portfolios, we're not talking like massive profitability here. I think it's 5.9% is the return on assets. So if you take away late fees, that's going to be a major hit to the industry, which is going to either reduce lending or drive people out, and then you get other things, like who knows if the Credit Card Act or the Credit Competition Act goes through regulating interchange fees? That could be another hit. It just seems like there's this movement of, on the margin, little changes that are aggregating to huge problems for a well-functioning financial market. But that's just my view as an economist. I'm not a lawyer.

Alan Kaplinsky:

Yeah. Well, we appreciate your thoughts, Andrew. My thanks today to our speakers, John Culhane, Kristen Larson, Ron Vaske, and our very special guest, Andrew Nigrinis.

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